Attribution Rule for Business Profits

NALSAR University of Law, M.A.
(International Taxation)

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Speaker

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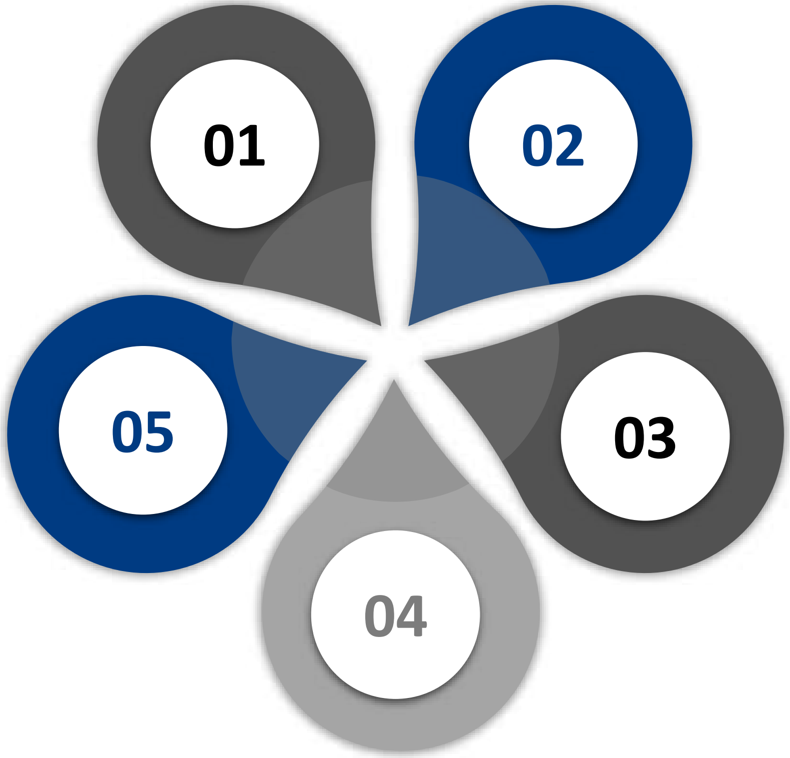
Importance of International Treaties



Digital Economy

Multiplicity of taxpayers' contacts with different countries

Complexities associated with modern commerce

Need for common agreement amongst countries

Achieving some measure of international tax order

Interpretation of Tax Treaties

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1. Law-making is a significant sovereign function
2. Flow of capital and resources
3. Contact with the laws and regulations of different jurisdictions
4. Increase in interactions between countries and people
5. Imperative to have international tax treaties in place for the smooth implementation and effective coordination
6. Vienna Convention on the Law of Treaties
   - **What is it?** -- an international agreement regulating treaties between countries
   - **What does it do?** -- it establishes comprehensive rules, procedures, and guidelines for how treaties are defined
   - **Is India a party to VCLT?** –- No, but Indian courts have applied VCLT principles while interpreting tax laws also
7. Fundamental principles while interpreting treaties
   - **Object**
   - **Purpose**
   - **Circumstances of Conclusion**
   - **Context**
   - **Good Faith**

Agenda

1. Taxing provisions under domestic law
2. International standards on attribution rules (OECD v UN)
3. India’s perspective on international standards
4. Profit attribution rules under domestic laws
5. Key issues and practical situations
6. Judicial trend on attribution rules

Taxation of Non-Residents

- Domestic Law— Section 9 – Business Connection
- Tax treaty – Permanent Establishment
- Layers of business which are vital for profit generation:
  - 1st: Production of goods / provision of services
  - 2nd: Sale to consumers
- Profits arising from business that is only partly carried out in a jurisdiction need to be attributed to that jurisdiction for the purpose of taxation

Example 01

- **HO** in **Netherlands**,
- **Raw Materials** from **Nigeria**,
- **Manufacturing** in **Mexico**,
- **Ships final products** via **Beligum** sea carrier to **Asian countries** for end consumers.

Example 02

- **Professional services** firm in **USA**
- **Employees** from **European countries**
- **Client** in **India** who is entering into a deal with an **Australian Seller** in relation to **South African** based target company,
- **Meeting with lawyers** occurred in **Argentina**, **Lawyers** reviewed documents in **Brazil**.

- Difficult to identify place of value creation in multi-jurisdiction transactions
- **Taxation**: If economic allegiance is an important factor to determine taxing rights, clear guidelines to determine location and revenue generation are required

Profit attribution rules under IT Act | Overview

- Section 5: Taxability of non-resident – nexus with India
- Section 9: Deemed to accrue or arise in India
- Business Connection: Several changes over the years—
  - Finance Act 2018: Business Connection amendment
  - Significant Economic Presence
- Income attribution: 'Reasonably' attributable
- Digital advertising and monetization: Following are deemed as income attributable to operations in India—
  - income from advertisement that targets Indian customers, or
  - income from sale of data collected from India, or
  - income from sale of goods and services using such data collected from India

Profit attribution rules under IT Act | Rule 10

- Profits and gains from business or profession: Taxpayers are required to maintain books of accounts and financial statements
- Importance: Primary onus to compute taxable profits on the taxpayer + systematic and scientific basis for attributing profits to India
- If books of accounts not maintained – Rule 10
- Rule 10 = Global Formulary Apportionment Approach i.e. 3 options—

Presumptive Method	Proportionate Method	Discretionary Method
Ad hoc percentage of the turnover	Receipts accruing or arising in India	As per tax officer

Tax Treaties | Permanent Establishment

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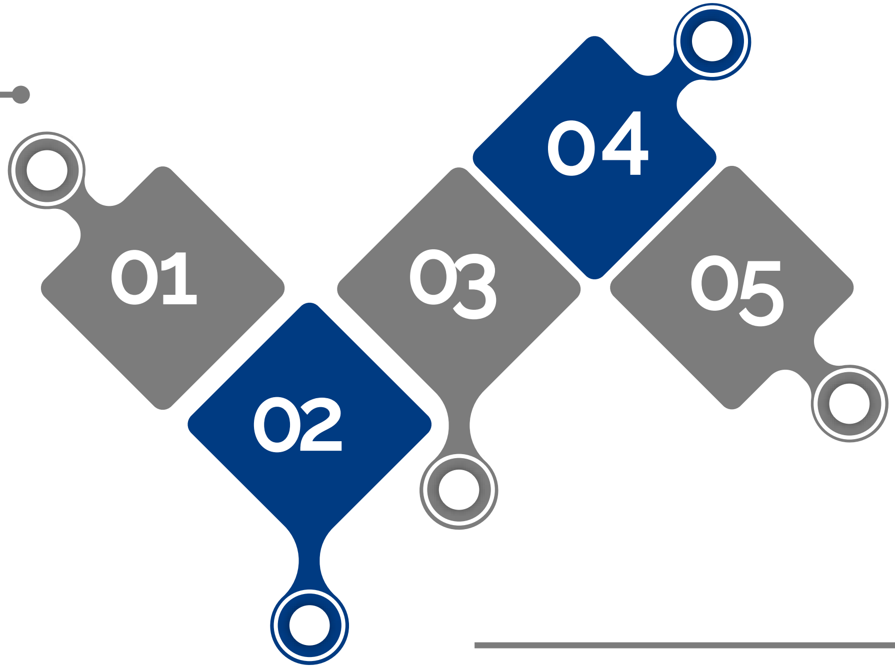
Permanent Establishment (PE)

Article 5

No PE = No tax



PE means a fixed place of business, through which the business of an enterprise is wholly or partly carried on.

PE determination is a fact-based exercise and would also differ for each industry. Recent expansion of the digital economy has increased the level of complexity and difficulty even more in relation to determination of PE

Includes branch, office, factory, workshop etc.

Tax Treaties | Permanent Establishment

Types of PE

Fixed Place PE	Construction PE	Supervision PE	Service PE	Agency PE

- Certain business activities have been listed as exceptions which when carried on through fixed places of business, are not sufficient for these places to constitute PEs.
- Character of PE: Preparatory v Auxiliary
- Key Q: Whether the non-resident is carrying on its own business in India
- India’s reservations on PE concept as per OECD Model— SEP, website, etc.

Tax Treaties | Profit Attribution Rules

Article 7	01	05	Source country's right limited to only those profits attributable to PE
Usually same across treaties, main difference being quantum of tax – based on mutual economic relations	02	06	If covered under any other article, then taxing rights determined accordingly
Determine which of the two countries may subject the income to their taxes: • Place where income arises, exclusively or by way of priority OR • Residence country v Source country	03	07	Arm's Length Principle
Business profits: Taxed in Residence country except when PE in Source country	04	08	To identify the quantum of taxable business profits for a Source country, important to have clarity on PE and related aspects

Evolution and History of International Tax Treaties

1. OECD Model v UN Model
2. Reference point for treaty negotiations
3. Commenced during League of Nations in 1920s
4. Key principles set out by 4 economists in 1923:
   a) Economic Allegiance
   b) Residence v Contribution
   c) Progressive taxes: Residence-based taxation
5. Constantly being updated over the years
6. India | Non-member of OECD
7. Commentaries on Model Tax Conventions | Great guide for attributions rules

Evolution and History of International Tax Treaties (Chronology)

1. League of Nations (1920s)
2. League of Nations' Model Treaty (1928)
3. Meeting in Mexico (1945) and London (1946) – starting point by OEEC and OECD
4. Fiscal Committee work (1956 onwards)
5. 4 Interim Reports: 1958 to 1961
Final Draft: 1963
6. Revisions to Draft Convention: 1963 to 1977
7. Adoption of 'Ambulatory' Model Convention: 1991
8. Publication of Model Convention in loose-leaf format: 1992
9. Addition of non-member nations' positions 2nd volume (including India)
10. Since 1st revision in 1992, Model Convention has been updated 10 times. Last update in 2017: BEPS and Action Plans

Standards of Profit Attribution Rules in Model Tax Conventions

Model tax conventions can be bifurcated into the following broad categories for the purpose of today's discussion:

- OECD Model Convention rule, pre-2010
- OECD Model Convention rule, post-2010
- UN Model Convention

OECD Model Convention Rule, Pre-2010

Restate and clarify Separate Entity and Arm's Length Principles with amendments

Article 7 of Draft Convention 1963

- Separate accounts
- Rectification of accounts
- Reference to formulae—(i) business receipts, (ii) expenses or (iii) capital structure

Appropriateness of any particular method will depend on the circumstances to which it is applied.

Example

- Providing services with high profit margin: Turnover
- Insurance enterprises: Premiums Received
- Manufacturing with high labour / raw material: Expenses
- Banks: Working Capital

Main aim

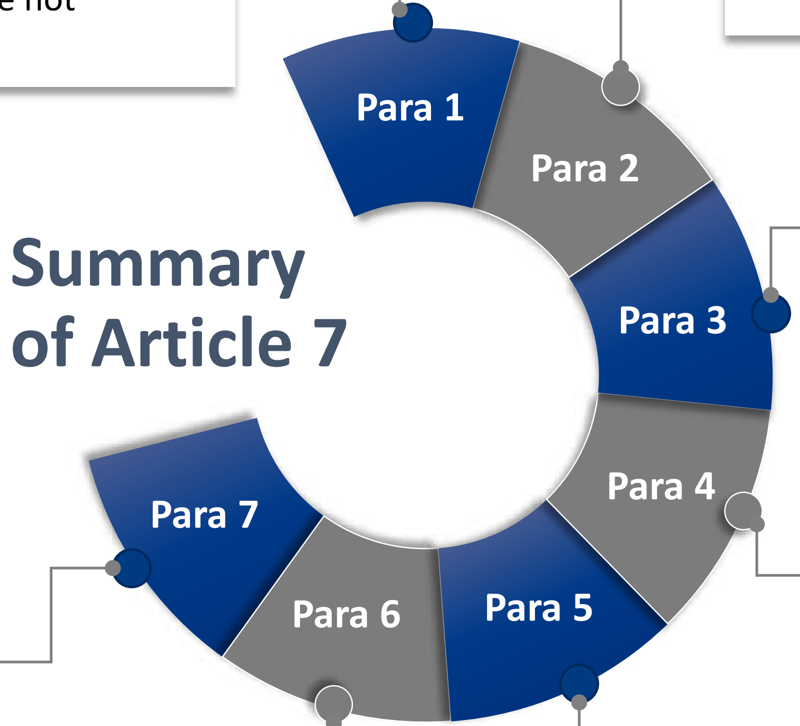
Produce figures of taxable profit that are as close to the figures that would have been produced on a separate accounts' basis

OECD Model Convention Rule, Pre-2010

Basic rules for allocating taxing rights on business profits of enterprises of each contracting state:

(a) Business activities through PE

(b) Taxing right ≠ profits of non-resident that are not attributable to PE



- **Para 1:** Basic rules for allocating taxing rights on business profits of enterprises of each contracting state (above)
- **Para 2:** Separate and distinct entity + Arm's Length Principle
- **Para 3:** Allowance for expenses of PE wherever incurred
- **Para 4:** Attribution of profits as per apportionment method if permitted by domestic law
- **Para 5:** Attribution of profits ≠ only because of purchase of goods by PE in the source country
- **Para 6:** Principle of Consistency – allocation method should not be changed easily
- **Para 7:** Order of precedence – 'specific over general' rule

OECD Model Convention Rule, Post-2010

Summary of Article 7

Para 1

Two fundamental principles

- If no PE in source country, business profits ≠ taxed in source country
- If there is a PE in source country, profits attributable to PE shall be taxed in source country

Para 2

- Separate and independent + FAR analysis + Arm's Length Principle

Para 3

- No double taxation

Para 4

- 'Specific over general' rule

OECD Model Convention Rule, Post 2010

- Separate Entity Approach
- Different from pre-2010
- **FAR analysis**: Functions, Assets, Risk
- Change in approach was significant in three ways:
  - **Profit Attribution** = *Transfer Pricing + Arm's Length Price v Arm's Length Principle*
  - **Taxation of Profits** = *solely depending on Supply Side Factors* i.e. ignoring contribution of market jurisdictions
  - **Omitting option of Apportionment =** *FAR analysis* ✓ *and Sales* ✗
- **<u>2 step approach</u>**:
  - **Step 1**: Functional and factual analysis of the PE + OECD TP guidelines
  - **Step 2**: Comparability analysis + Arm's length return
- India does not contain the revised version of OECD's Article 7 which prescribe profit attribution by way of FAR analysis

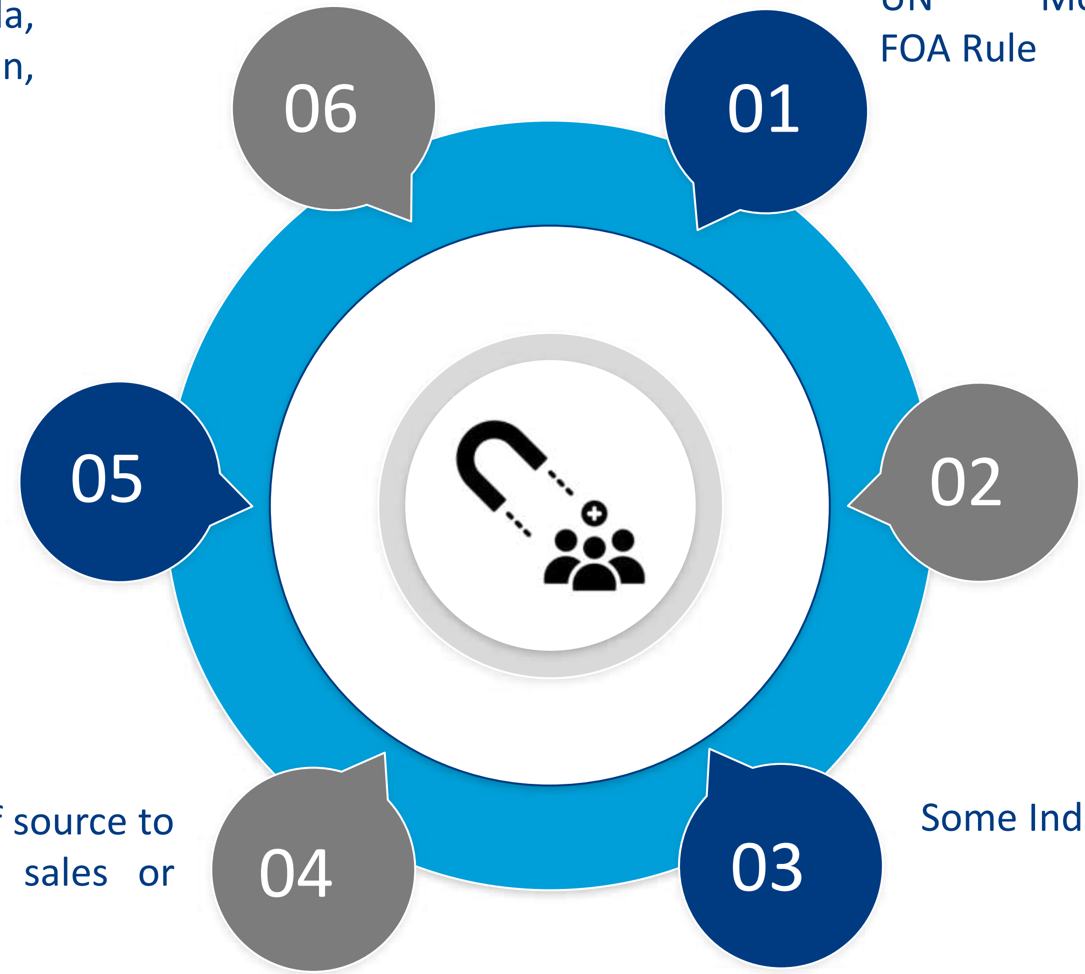
UN Model Convention

Common feature with pre-2010 OECD Model: Acceptance of the right of source country to apply an apportionment method in accordance with its domestic laws

Differences with pre-2010 OECD Model: *(explained in detail in the next slides)*

- Force of Attraction
- Limitation of Deductible Expenses

Force of Attraction



01 UN Model Convention— Limited FOA Rule

02 Meaning: Levying of source country tax in case there is PE and the entire business income is directly or indirectly related to the activities carried on through such PE

03 Some Indian DTAAs provide for this principle

04 Establishes the right of the country of source to tax all profits derived from such sales or business from within its territory

05 Based on the logic that the source country also contributes by facilitating the demand side factors

06 E.g. New Zealand, Belgium, Canada, Denmark, Italy, Poland, Portugal, Spain, Germany

Limitation of Deductible Expenses

01

UN model provision restricts the deductibility of expenses while also prohibiting the taxation of any receipts of the PE from the head office on their account

02

In line with the economic reality of the business: Such payments are NOT operational expenses

03

Ensures that actual profits of the enterprise derived by the PE from the country of source are subjected to tax therein, without any notional adjustments for sunk costs borne outside that tax jurisdiction

India’s View

01

Indian treaties largely based on UN Model Convention or pre-2010 OECD Model Convention

02

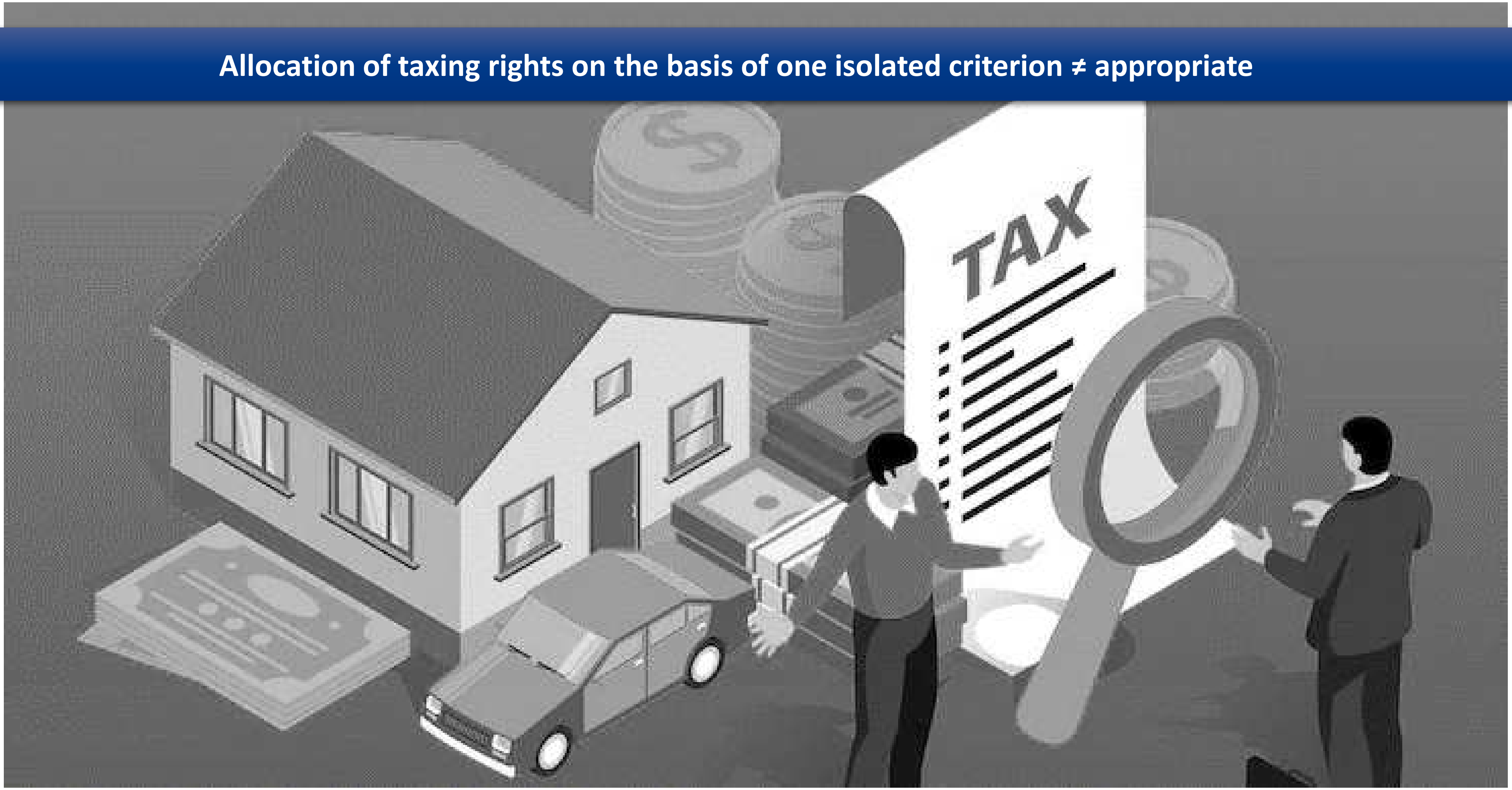
India has explicitly expressed that it does not agree with the 2010 update and that it reserves the right to use the previous version of Article 7

03

This is because the 2010 update by OECD disregards the *demand side factors* completely

Economic basis for allocating taxing rights for business profits | Value Creation

Allocation of taxing rights on the basis of one isolated criterion ≠ appropriate



Economic basis for allocating taxing rights for business profits | Value Creation

Supply side factors solely cannot be considered

- Importance of demand forecast cannot be ignored
- Tax base is 'business profits', which can arise only when an economic good is sold to the consumer
- Profits are created by sales and not just by inventories
- Purchasing Power Parity
- 'Willingness to pay for a good' is directly dependent on the 'ability to pay'

Economic basis for allocating taxing rights for business profits | Value Creation

Similarly, solely demand side factors cannot be considered

- Demand without supply will not generate revenue or profits
- Without investing in resources for supplying the product, demand will have no relevance
- No profits can be generated without production

Economic basis for allocating taxing rights for business profits | Value Creation

Both production and sales are essential for the generation of profits

a. VAT = tax where value is created + destination-based rule

b. Income tax ≠ value addition, = business profits

Important to analyse where value creation takes place

Formula: *Profits of an enterprise = (Price per unit x quantity of units sold) – (Sum of marginal costs for all units + assigned sunk cost)*

If we analyse each element of this formula, we will find that supply side factors as well as demand side factors together lead to profit generation for an enterprise.

Judicial Trends

1. Courts have adopted or approved different methods of attributing profits to PE
2. Based on peculiar facts and circumstances of the case
3. Profit attribution has ranged from 0% to 75%
4. Anglo French Textile Company Limited v. CIT *[1952 23 ITR 101 (SC)]*

Judicial Trends

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5

Hukum Chand Mills Limited v. CIT *[103 ITR 548 (SC)]*

6

Key principle: For computing the quantum of profits attributable to India, the method of apportionment should be aligned to the facts, circumstances and the economic realities of the business

7

Repeatedly highlighted the right of the Assessing Officer to attribute profits under Rule 10

8

Various methodologies have been used to attribute profits under Rule 10 – creates uncertainties for taxpayers and increase in tax disputes

Proposal for Amendment of Rule 10

Expert Committee was constituted

- Examine the issues related to profit attribution to PE in India
- Recommend changes to Rule 10

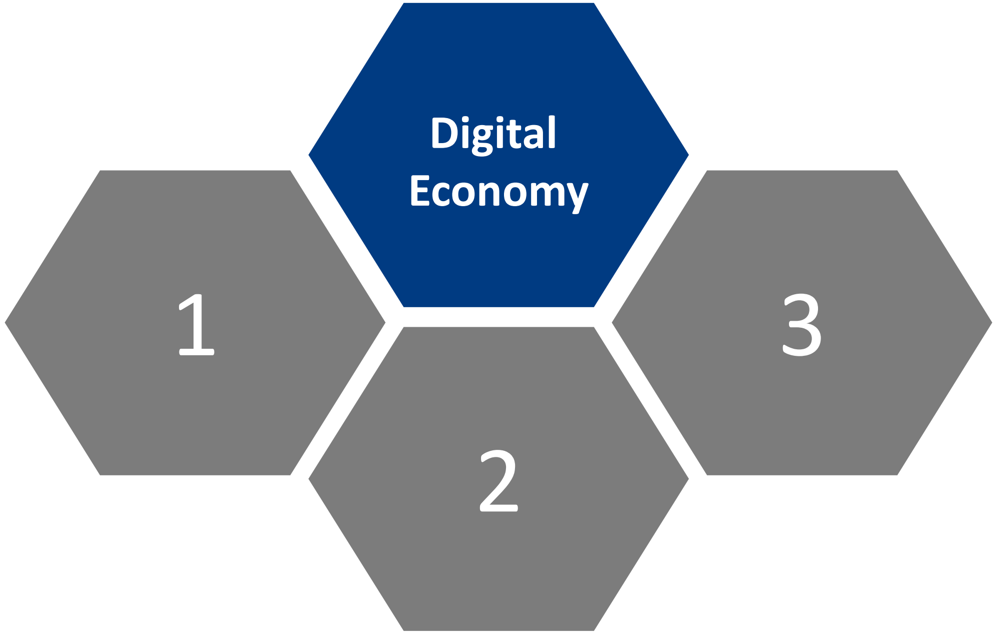
Options to adopt a uniform method of profits attribution by apportionment

- Formulatory Apportionment
- Fractional Apportionment
- SC ruling (DIT v Morgan Stanley): Profits derived from Indian operations that have already been subjected to tax in India = deducted from the apportioned profits

Profits derived from India need to be defined objectively

Deeming the global operational profit margin to be 2%

Proposal for Amendment of Rule 10



For business models in which users contribute significantly to the profits of the enterprise, they should also be taken into account

Lowering weight of 10% to the users for those business models involving low or medium user intensity and assigning a weightage of 20% to users in those business models involving high user intensity

Relative weightage of employees and assets to be adjusted downwards, keeping the weightage of sales fixed at 30% in both the cases

Finance Act 2023 amendment | Royalty FTS tax rate increase

01 Royalty / FTS tax rate under domestic tax law: 10% → 20%. Subject to beneficial treatment (if any) available under applicable tax treaty relief ('Make available' clause for FTS)

02 Interplay between Royalty taxation @ 10% vs business profits taxation @ 40% with WHT obligations

03 FA 2023 amendment as part of budgetary amendment proposals | Conflicting views that will be preferred by payee and payer

04 Impact on WHT obligations in view of penal consequences for payer's default → payers may take conservative views, more contractual protections etc

05 Tax treaty relief eligibility aspects becoming important | TRC + Beneficial ownership + subjective elements

06 Interplay with business profits taxation going forward

Conclusion

01

India does not agree with the approach to the attribution of profits to that has been laid down in the revised OECD Article and in its Commentary—it reserves the right to use previous version of Article 7

02

For allocation of taxing rights, consider demand as well as supply side factors

03

Process of identifying ‘economic allegiance’ will always remain dynamic in nature

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